



Bill Draft 2011-RBz-18A: Expedited Rulemaking for Forced Combination.

2011-2012 General Assembly

Committee: Revenue Laws Study Committee
Introduced by:
Analysis of: 2011-RBz-18A

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SUMMARY: *This draft requires the Department of Revenue to adopt rules regarding its interpretation of G.S. 105-130.5A, the Secretary's authority to redetermine the State net income of a corporation properly attributable to its business carried on in the State by adjusting its net income or requiring it to file a combined return. The draft provides an expedited rule-making process for these rules.*

CURRENT LAW: The tax laws in Chapter 105 of the General Statutes contain two statutes that appear to give the Department of Revenue two different pathways of interpreting the law:

- G.S. 105-264 – It provides the Secretary may interpret a law by adopting a rule *or by publishing a bulletin or directive* on the law. The Department has interpreted tax law through the issuance of bulletins¹ or directives² since at least 1955. This process does not involve public notice and comment or approval by any outside authority. Bulletins and directives may be issued immediately. A directive or bulletin is not considered a binding interpretation on the courts.
- G.S. 105-262 – It provides the Secretary may adopt rules under Chapter 150B. The Department is exempt from the notice and hearing provisions of Part 2 of Article 2A of Chapter 150B. Although the rule-making process does not provide an opportunity for public notice and hearing for rules adopted by the Department, it does provide a review of the rules by the Rules Review Commission (RCC). The RCC reviews rules to ensure they do not exceed an agency's statutory authority. A rule is considered a binding interpretation on the courts. The definition of a rule in G.S. 150B-1 specifically states that a rule does not include nonbinding interpretative statements that merely define, interpret, or explain the meaning of a statute or rule and that a rule does not include statements that set forth criteria or guidelines to be used by the staff of an agency in performing audits, investigations, or inspections.

BILL ANALYSIS: *Legislative Proposal #1* would require the Department of Revenue to adopt rules before it could exercise the authority under G.S. 105-130.5A³ to redetermine the State net income of a corporation properly attributable to its business carried on in the State by adjusting its net income or requiring it to file a combined return. The proposal does not extend the rulemaking requirement to all

¹ Bulletins present the Department of Revenue's administrative interpretation and application of tax laws. The Department has 'Corporate, Excise, and Insurance Tax Bulletins', 'Individual Income Tax Bulletins', and 'Sales and Use Tax Bulletins'. The Department typically updates the bulletins annually to reflect changes in the law or administrative interpretation. However, the Department has not updated the bulletins in the last three or four years.

² Directives are issued by the Department of Revenue on an as-needed basis to interpret a tax law, explain the application of law to stated facts, or to clarify an issue on which the Department has received numerous questions. Directives are not updated to reflect changes in the law or administrative interpretation. The contents of a directive may be included in an updated bulletin.

³ S.L. 2011-390, as amended by S.L. 2011-411, repealed the statutes that allowed the Secretary to redetermine the net income of a corporation if the Secretary found that a report by the corporation did not reflect its true earnings from its business carried on in this State. In their place, the General Assembly enacted a more restrictive interpretation in G.S. 105-130.5A. Effective for taxable years beginning on or after January 1, 2012, the Secretary must find that the corporation fails to accurately report its State net income through the use of transactions that lack economic substance or are not at fair market value.

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interpretations of the tax laws by the agency because there did not appear time to address the issues a larger proposal would entail:

- A clear understanding of what interpretations would require a rule. The current definition of a rule does not include nonbinding interpretative statements or statements that set forth criteria or guidelines to be used by the staff of an agency in performing audits. Arguably, the Department's bulletins would fall within these exceptions to the definition of a rule in Chapter 150B.
- A clear understanding of the status of the bulletins and directives that currently exist. Would they all have to be adopted through the rulemaking process? Would they be grandfathered into effectiveness? Do they meet the definition of a rule? Do they need to be published in the North Carolina Administrative Code (Code)?

Throughout the course of the Revenue Laws Study Committee meetings on the implementation of G.S. 105-130.5A, the members expressed strong concerns on the need for the Department to provide clarity on the law for taxpayers and to execute the law as enacted. In response to the change in the law and the legislative concern on the interpretation of the law, the Department issued the first Corporate Tax Directive⁴ it has issued since 2008. Representatives on behalf of the North Carolina Chamber of Commerce, the North Carolina Retail Merchants Association, and the Council on State Taxation appeared before the Committee on March 7, 2012, and expressed concern that the directive issued by the Department did not provide clarity to the law, exceeded the Department's statutory authority, and did not undergo the formal rule-making process.⁵ The Department of Revenue expressed concern about the length of the rule-making process.

This proposal seeks to balance the following three goals:

- The need for taxpayer certainty about the tax laws.
- The need for an outside determination as to whether the Department of Revenue has exceeded its statutory authority in its interpretation of the law.
- The opportunity for public notice and comment on the Department's interpretation of the law.

The proposal provides the rulemaking procedure will be the quicker timetable allowed for temporary rulemaking. This process may be completed in less than two months. This process allows 15 days for notice and comment from outside parties. Anyone may object to a proposed rule during the notice and comment period or within three business days of the adoption of the rule by requesting review by the RRC. To ensure that all parties have knowledge of the adoption of a rule, the proposal requires the Department to provide electronic notification of its adoption of a rule to persons on the mailing list, those originally given notice of the rulemaking, and those who provided comment on the rule. If no one requests review by the RRC, the adopted rule may be delivered to the Codifier of Rules and entered into the Code. If the Department receives written objections to the rule and requests that the rule be reviewed, then the RRC must review the rule within 15 days. The RRC may not extend the period of time for review. As provided in G.S. 150B-21.9, the RRC does not consider questions relating to the quality or efficacy of the rule, but limits its review to the following:

- Is the rule within the authority delegated to the agency?
- Is it clear and unambiguous?
- Is it reasonably necessary to implement or interpret an act of the General Assembly or of Congress or of a regulation of a federal agency?

⁴ [Corporate Income Tax Directives Table of Contents](#)

⁵ [North Carolina General Assembly - Revenue Laws > Meeting Documents > 2011-2012 Meeting Documents > March 7](#)

- Was it adopted in accordance with G.S. 105-262A?

The proposal changes the fiscal note requirement to allow Revenue to prepare its own fiscal note.⁶ It will not need to submit the fiscal note to the Office of State Budget and Management. The fiscal note must be submitted with the proposed rule to the Codifier of Rules and posted on the Internet. A person may comment on the fiscal note in the same manner a person may comment on a proposed rule. Section 4 of the bill provides that the Department does not need to prepare a fiscal note for a proposed rule submitted to the Codifier of Rules prior to December 31, 2012. The reason for this waiver is that any rules submitted before the end of this calendar year under the statute created by this act is limited to the Department's application of G.S. 105-130.5A. The subject of the rule has been debated in the General Assembly during the 2011 session, where the Fiscal Research Division prepared a fiscal memo, and it has been the subject of four Revenue Laws Study Committee meetings in 2011 and 2012. The fiscal issues surrounding this particular rule appear to be well known and understood by all the parties.

The proposal exempts the Department from the delayed effective date provisions that apply whenever the Commission receives 10 or more objections to a rule requesting review by the legislature.

A rule becomes effective on the last day of the month the Codifier of Rules enters the rule in the Code. This effective date provision differs from the general effective date provision in Chapter 150B⁷ and enables the rule to become effective a month earlier. Section 6 of the draft clarifies that the Secretary's authority under G.S. 105-130.5A exists continuously for taxable years beginning on or after January 1, 2012. After a rule becomes effective, the Secretary may issue a proposed denial of a refund or a proposed assessment under the authority of G.S. 105-130.5A for any taxable year that beginning on or after January 1, 2012.

The proposal only applies to G.S. 105-130.5A. It does not apply to the Secretary's interpretations of the repealed statutes that continue to be applicable for taxable years beginning before January 1, 2012: G.S. 105-130.6, 105-130.15, and 105-130.16. The Department has issued a directive offering guidance on its interpretation of those laws, CD-12-01, and the directive appears to set forth the Department's application of the law as upheld by the North Carolina Courts.⁸ The Department has also issued a directive offering guidance on its interpretation of the newly enacted law, G.S. 105-130.5A, in CD-12-02. Section 5 of the bill provides that a taxpayer who relied upon the interpretation in that Directive and whose North Carolina taxable income for the 2012 taxable year is less under the Directive's interpretation than under an interpretation adopted through the rulemaking process may rely on the interpretation under the Directive for the 2012 taxable year.

EFFECTIVE DATE: The proposal would become effective when it becomes law.

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⁶ A fiscal note must be prepared if the rule has a substantial economic impact. Prior to 2011, the term 'substantial economic impact' meant a cumulative impact of \$3,000,000. In 2011, this amount was reduced to \$500,000.

⁷ G.S. 150B-21.3 provides that a rule becomes effective on the first day of the month following the month the rule is approved.

⁸ *Wal-Mart Stores East v. Hinton*, 197 N.C. App. 30 (2009); *Delhaize America, Inc., Plaintiff, v. Kenneth R. Lay*, 2011 NCBC 2: 2011 NCBC LEXIS 9 (2011).